

ISSUE DATE: June 22, 1998

DOCKET NO. E-017/AI-98-400

ORDER APPROVING ASSET TRANSFER AND REJECTING PROPOSED PURCHASE
AGREEMENT

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Edward A. Garvey
Joel Jacobs
Marshall Johnson
LeRoy Koppendrayer
Gregory Scott

Chair
Commissioner
Commissioner
Commissioner
Commissioner

In the Matter of a Request by Otter Tail Power
Company for Commission Approval of an
Asset Transfer Agreement and a Purchase
Agreement between Otter Tail and a Newly
Incorporated Wholly-owned Subsidiary

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PROCEDURAL HISTORY

On October 17, 1997, the Commission issued its ORDER MODIFYING SETTLEMENT in Docket No. E-017/PA-97-697. In that Order the Commission allowed Otter Tail Power Company (Otter Tail) to transfer the plant and inventory associated with its operation of a high voltage testing laboratory to an unregulated subsidiary. The Commission approved a settlement reached between Otter Tail and the Department of Public Service (the Department), by which Otter Tail would reduce its revenue requirement by \$75,542 for each of the ten years following the Company's next rate case filing. The reduction in revenue requirement was meant to guarantee that ratepayers would not be adversely impacted by the property transfer from regulated to nonregulated operations.

On March 23, 1998, Otter Tail filed a petition for approval of the actual transfer of assets to its newly-formed subsidiary, Mid-States Testing (Mid-States). Otter Tail described this part of the petition as a housekeeping matter. Otter Tail also asked for approval of a purchase agreement under which Otter Tail would purchase protective rubber goods and testing services from Mid-States. Subject to Commission approval, the agreement would provide for purchases of the goods and services for a period of one year without a competitive bidding process. At the end of the year, after the startup nonregulated operational has become functional, Otter Tail would conduct competitive bidding. Otter Tail argued that this arrangement is consistent with the public interest because the affiliated interest statutes do not require bidding in all cases, because Mid-States will not charge more than the prices previously charged by the regulated operation, and because the previously approved settlement protects ratepayers from any adverse impact from the transfer of testing operations. Finally, Otter Tail asked for a variance from Minn. Rules, part 7825.2100, under which a public utility is required to obtain Commission approval prior to entering into a contract with an affiliate.

On April 22, 1998, the Department filed comments recommending approval of the asset transfer and rejection of the proposed purchase agreement. The Department stated that it could not judge if the purchase agreement is consistent with the public interest without a competitive bidding

process to determine fair market prices. The Department argued that the relationship between Otter Tail and its affiliate does not justify Otter Tail's allowing the new entity a one-year startup without competition from other suppliers.

On May 8, 1998, Otter Tail filed reply comments. Otter Tail argued that it had offered a legitimate reason for proceeding without bidding during a transitional phase--the inability of Mid-States, as a startup entity currently without assets or an operational history, to submit a meaningful proposal. The affiliated interest rules only require a satisfactory explanation of a utility's choice to proceed without bidding; Otter Tail stated that it has supplied the explanation and thus satisfied the rule requirements. Otter Tail argued that, absent cross-subsidization, Otter Tail management has the authority to choose its service suppliers. According to Otter Tail, ratepayers have been fully protected against cross-subsidization and the Company should therefore be allowed to proceed under its proposed plan.

On June 11, 1998, the matter came before the Commission for consideration.

FINDINGS AND CONCLUSIONS

I. THE ASSET TRANSFER

In its October 17, 1997 Order, the Commission approved Otter Tail's transfer of plant and inventory associated with its high voltage testing laboratory to its newly formed subsidiary. Otter Tail is now asking for approval of the actual transfer of net book value of approximately \$316,000 in equipment and inventory, effective April 1, 1998.

The Commission finds that the transfer is consistent with the public interest and should be approved. The Commission agrees with the Department that the affiliated interest rules require Otter Tail to file an administrative services agreement and tax sharing agreement for this transfer of assets between affiliates. The Commission will so order.

II. THE PROPOSED PURCHASE AGREEMENT

The affiliated interest statutes and rules create a set of safeguards under which affiliates may transact business without detriment to ratepayers. The statutes and rules reflect the fact that affiliates may work together to their mutual benefit. At the same time, the regulatory provisions reflect the possibility of cross-subsidization and are constructed to prevent such an occurrence by opening inter-affiliate transactions to broad scrutiny. Thus, the statutes and rules call for comprehensive filing requirements and Commission approval of many inter-affiliate agreements. The rules attempt to create a market test for the reasonableness of affiliate transactions by requiring a competitive bidding process. If the utility does not engage in competitive bidding, it must file an explanation of its decision.

Minn. Stat. § 216B.48, subd. 3 provides two tests for the Commission's consideration of

affiliated interest contracts--reasonableness and consistency with the public interest. The statute states that the utility has the burden of proof to show that the proposed agreement passes the two-prong Commission test. A utility's decision to forego competitive bidding must therefore pass the Commission's overall tests of reasonableness and consistency with the public interest.

In this case, Otter Tail has failed to provide a satisfactory explanation for its decision to conduct business with its affiliate without a bidding process. Absent a preexisting affiliate relationship, it is difficult to imagine a utility choosing a startup supplier such as Mid-States, with all new employees and without a proven track record, over existing competitors. In the real world of competition (where a nonregulated affiliate should dwell), Mid-States' lack of ability to produce a meaningful bid seems less a logical reason to proceed without bidding than a caution against choosing this supplier over available, experienced competitors.

Otter Tail's arguments that its ratepayers will not be harmed do not justify its choice of Mid-States without a bidding process. The Department has had continued concerns about the level of prices offered by Mid-States. Protection of ratepayers from adverse rate consequences from the affiliate spin-off does not automatically answer the Department's questions on price. Neither are the Department's concerns answered by the fact that Mid-States will not raise its prices. Competitive bidding is meant to provide the yardstick by which prices between affiliates are judged; competitive bidding is necessary in this set of circumstances.

For these reasons, the Commission will not approve Otter Tail's proposed purchase agreement with Mid-States. Given Otter Tail's previous choice of an unproven testing services supplier, the Commission will also require the Company to document in any future bidding filing that its chosen provider has a reasonable history of testing and a demonstrated reliability in this field of products and services.

Finally, because the Commission is rejecting the proposed purchase agreement, the Commission will also reject Otter Tail's request for a variance from Minn. Rules, part 7825.2100 for this portion of the petition.

ORDER

1. The Commission approves Otter Tail's requested asset transfer, with the requirement that the Company file administrative services and tax agreements.
2. The Commission denies Otter Tail's request for approval of its proposed purchase agreement with Mid-States Testing.

3. In a future bidding process to determine its choice of a supplier of protective rubber goods and testing, Otter Tail shall document that its chosen provider has a reasonable history of testing and a demonstrated reliability in this field of products and services.
4. The Commission denies Otter Tail's request for a variance from Minn. Rules, part 7825.2100.
5. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

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